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## **Holding Out for a Change: Why North Carolina Should Permit Holder Claims\***

### **INTRODUCTION**

Securities have been regulated for many years and continue to be subject to changing rules.<sup>1</sup> Despite extensive securities regulations, a gap still exists in North Carolina that prevents adequate relief for individual securities holders who have suffered losses based on misrepresentations by a corporation's officers or directors. A prime example of this gap was recently before the North Carolina Court of Appeals in *Estate of Browne v. Thompson*.<sup>2</sup> This case involved seven individual plaintiffs who owned and retained shares of Wachovia Corporation ("Wachovia") stock during a period of large financial losses in which officers filed false reports with the U.S. Securities and Exchange Commission ("SEC") and withheld other material information from shareholders.<sup>3</sup> When information regarding Wachovia's financial decline finally came to light, the plaintiffs' stock plummeted in value.<sup>4</sup>

Had the plaintiffs in this case been induced to buy new shares of stock or sell shares that they owned based on the officers' and directors' misrepresentations, they would have had recourse in their individual capacities under SEC Rule 10b-5.<sup>5</sup> Instead, because the plaintiffs were "holders" who retained stock that they already owned, there was no avenue for individual relief even though the plaintiffs suffered financial loss as a result of the defendants' misrepresentations.<sup>6</sup>

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1. See Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (2012)); Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78pp (2012)). Within the past 20 years, the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C. (2012)), and the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered sections of 15 U.S.C. (2012)), have been enacted to control the number of and fora for securities actions that shareholders may bring.

2. \_\_ N.C. App. \_\_, 727 S.E.2d 573 (2012).

3. See Complaint at 1-2, *Browne v. Thompson*, No. 09 CVS 8588, 2011 WL 1675000 (N.C. Bus. Ct. Feb. 23, 2011), 2009 WL 8631784, at \*1.

4. *Id.*

5. See 17 C.F.R. § 240.10b-5 (2013); *infra* notes 36-38 and accompanying text.

6. See *Estate of Browne*, \_\_ N.C. App. at \_\_, 727 S.E.2d at 575-76. As will be discussed in Part II, a derivative suit brought by the shareholders on behalf of the

There are two primary reasons behind the lack of an individual remedy for the plaintiffs in *Estate of Browne* and similar cases: (1) federal law places restrictions on the securities claims that may be brought;<sup>7</sup> and (2) North Carolina does not recognize holder claims, which are claims for damages based on the idea that a defendant's misrepresentation caused a shareholder to "hold" onto his or her stock when the shareholder would have otherwise sold the stock.<sup>8</sup> This Recent Development argues that North Carolina should recognize holder claims and provide a legal remedy for shareholders who suffer financial losses because they retained their stock after relying on misrepresentations by corporate directors or officers. However, like other states, North Carolina should limit holder claims by adopting heightened pleading requirements. Such pleading requirements balance the interests of corporations and courts—who seek to avoid frivolous litigation—with the interests of shareholders—who aim to recoup losses induced by misrepresentation and encourage ethical actions of corporate officers and directors.

Analysis proceeds in four parts. Part I presents the facts of *Estate of Browne v. Thompson*. Next, Part II discusses the minimal avenues of recourse currently available to shareholders under North Carolina law, as well as the limitations that exist under federal law. Part III discusses how other states have addressed the issue of holder claims, particularly focusing on the limitations and heightened pleading requirements imposed in California, a state that allows holder claims. Finally, Part IV argues that North Carolina should follow the lead of states like California by permitting limited holder claims. Doing so would advance the interests of shareholders by allowing for the possibility of an additional remedy not presently available while still sparing courts and corporations from an influx of meritless litigation.

### I. *ESTATE OF BROWNE V. THOMPSON*

In 2012, the North Carolina Court of Appeals decided *Estate of Browne v. Thompson*, a case brought by shareholders of Wachovia.<sup>9</sup> The shareholders' Wachovia stock plummeted in value following the corporation's acquisition of Golden West Financial Corporation

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corporation would have been possible; however, the court of appeals did not permit a direct, individual suit to be brought under these facts.

7. See *infra* Part II.A.

8. See *Estate of Browne*, \_\_ N.C. App. at \_\_, 727 S.E.2d at 576; *infra* note 25 and accompanying text.

9. *Estate of Browne*, \_\_ N.C. App. at \_\_, 727 S.E.2d at 574.

(“Golden West”).<sup>10</sup> Golden West had issued loans to borrowers without adequately checking the creditworthiness of those borrowers, using underwriting standards that the *Estate of Browne* plaintiffs claimed were “‘risky’ and insufficient to determine adequately the creditworthiness of borrowers.”<sup>11</sup> After being acquired by Wachovia, Golden West’s “risky” underwriting practices backfired in light of the rapid deterioration of the national housing market during the mid-2000s. As a result, Wachovia experienced “unprecedented losses” from 2006 to 2008.<sup>12</sup>

Seven individual shareholders directly sued Wachovia, Wachovia’s successor Wells Fargo & Company (“Wells Fargo”), Wachovia’s auditor KPMG LLP, and the former Wachovia directors who served during the time of the Golden West acquisition and the subsequent drop in Wachovia’s stock price.<sup>13</sup> The shareholders claimed that the former directors “concealed information regarding underwriting standards, collateral quality, and necessary reserves for loans” and also “issued false public SEC filings, press releases, and earnings calls regarding Wachovia’s financial strength and stability” from the time of the Golden West acquisition in 2006 until September 2008, when Wachovia merged with Wells Fargo.<sup>14</sup> The shareholders argued that they relied on the former directors’ misrepresentations when they made the choice to continue holding their Wachovia stock.<sup>15</sup>

The plaintiffs’ suit was dismissed by the North Carolina Business Court,<sup>16</sup> and the North Carolina Court of Appeals ultimately affirmed

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10. *Id.* at \_\_\_, 727 S.E.2d at 574–75.

11. *Browne v. Thompson*, No. 09 CVS 8588, 2011 WL 1675000, at \*1–2 (N.C. Bus. Ct. Feb. 23, 2011), *aff’d sub nom.* *Estate of Browne v. Thompson*, \_\_ N.C. App. \_\_, 727 S.E.2d 573 (2012). In addition to the riskiness of the borrowers, the loans offered by Golden West, known as “Pick A Pay” loans, had the potential to result in negative amortization, “meaning the principal balance of the loan increases, rather than decreases,” if borrowers only paid the minimum payment due each month. *Id.* at \*1. The court noted, “[N]egative amortization could cause a borrower to owe more than the property is worth.” *Id.*

12. *Id.* at \*2.

13. *Estate of Browne*, \_\_ N.C. App. at \_\_, 727 S.E.2d at 574–75.

14. *Id.* at \_\_, 727 S.E.2d at 575. By the time of the merger, Wachovia’s stock was worth less than one dollar per share. *Id.* Wachovia shareholders were given only 0.1991 shares of Wells Fargo stock for each share of Wachovia stock they had when the merger occurred. *Id.*

15. *See id.*

16. *See Browne*, 2011 WL 1675000, at \*5, \*8. The North Carolina Business Court is a specialized trial-level state court tasked by the Chief Justice of the Supreme Court of North Carolina with overseeing “[c]ases involving complex and significant issues of corporate and commercial law.” *About the Court*, N.C. BUS. COURT, <http://www.ncbusinesscourt.net/New/aboutcourt/> (last visited Feb. 7, 2014). Specifically,

the Business Court's dismissal.<sup>17</sup> The court of appeals first discussed the general rule in North Carolina that "shareholders cannot pursue individual causes of action" when the value of their stock is harmed.<sup>18</sup> Rather, shareholders can typically only pursue derivative actions, which are actions brought by shareholders in their capacity as representatives of the corporation against directors, officers, or others whose frauds or misrepresentations cause harm to the value of the corporation.<sup>19</sup> In derivative suits, any damages awarded by the court go to the corporation rather than directly into the pockets of any individual shareholders.<sup>20</sup>

Judge Steelman's majority opinion in *Estate of Browne* discussed two exceptions to the general rule that shareholders can only bring derivative actions. Established in the case of *Barger v. McCoy Hillard & Parks*<sup>21</sup> and known as *Barger* exceptions, North Carolina allows shareholders to bring individual causes of action if (1) the defendant owed a special duty to the shareholder or (2) the shareholder suffered a different injury than the other shareholders.<sup>22</sup> The court of appeals in *Estate of Browne* ultimately concluded that the plaintiffs did not fall into either exception, and therefore, the plaintiffs could not bring the suit in their individual capacities.<sup>23</sup> Without the ability to bring suit in their individual capacities or claim an individual remedy in a

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the North Carolina Business Court can hear cases pertaining to securities law, antitrust law, intellectual property law, and other subjects deemed by statute to constitute a "mandatory complex business case." N.C. GEN. STAT. § 7A-45.4(a) (2013). Parties to cases involving such subject matters may remove from superior court to the North Carolina Business Court by filing a Notice of Designation with the local superior court, the Senior Business Court Judge, the Chief Justice of the Supreme Court of North Carolina, and all other parties to the case. *Id.* § 7A-45.4(b). If any other party believes that a case should not be considered a "mandatory complex business case" under the statute, it may file an opposition within thirty days of receiving the Notice of Designation. *Id.* § 7A-45.4(e). In addition to subjects deemed by statute to be "mandatory complex business cases," superior court judges also have the discretion to recommend that cases be designated "complex business cases" or "exceptional cases" and heard by the North Carolina Business Court. See Memorandum from Supreme Court of N.C. Chief Justice I. Beverly Lake, Jr. to Superior Court Judges 2 (Mar. 7, 2001), available at <http://www.ncbusinesscourt.net/New/links/CJ%20Guidelines%203%2007%2001.pdf>. This recommendation can be made at the request of the parties or on the judge's own motion, and judges may make this recommendation over a party's objection. See *id.*

17. See *Estate of Browne*, \_\_ N.C. App. at \_\_, 727 S.E.2d at 574.

18. *Id.* at \_\_, 727 S.E.2d. at 575 (quoting *Barger v. McCoy Hillard & Parks*, 346 N.C. 650, 658, 488 S.E.2d 215, 219 (1997)).

19. See JAMES D. COX & THOMAS L. HAZEN, BUSINESS ORGANIZATIONS LAW § 15.2 (3d ed. 2011).

20. See *id.*

21. 346 N.C. 650, 488 S.E.2d 215 (1997).

22. See *id.* at 658, 488 S.E.2d at 219.

23. *Estate of Browne*, \_\_ N.C. App. at \_\_, 727 S.E.2d at 575–76.

derivative suit, the plaintiffs asserted that they were entitled to damages through a holder claim.<sup>24</sup> A holder claim is a suit brought for damages based on the fact that an individual shareholder suffered financial loss after retaining stock for longer than he or she otherwise would have as a consequence of an officer's or director's misrepresentation.<sup>25</sup> The plaintiffs in *Estate of Browne* argued that North Carolina case law had previously recognized holder claims in the case of *Gilbert v. Bagley*<sup>26</sup> and that the court should do so again in this instance.<sup>27</sup> In *Gilbert*, the federal district court for the Middle District of North Carolina, relying on section 55-35 of the North Carolina General Statutes<sup>28</sup> and the Supreme Court of North Carolina's decision in *Underwood v. Stafford*,<sup>29</sup> determined that shareholders have an individual cause of action against officers and directors who violate their fiduciary duties to shareholders.<sup>30</sup> The *Gilbert* court highlighted that "[t]he shareholder plaintiffs' injury, i.e., inducement to either *hold* or purchase shares in the Company as a result of the alleged scheme, is peculiar to them" and thus constitutes an individual, rather than a derivative, cause of action.<sup>31</sup> However, the *Estate of Browne* court noted that the statute relied upon by the

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24. *Id.* at \_\_\_, 727 S.E.2d at 576.

25. See *Small v. Fritz Cos.*, 65 P.3d 1255, 1256–57 (Cal. 2003) (defining a "holder's action" as "a cause of action by persons wrongfully induced to *hold* stock instead of selling it."); *Harris v. Wachovia Corp.*, No. 09 CVS 25270, 2011 WL 1679625, at \*11 (N.C. Bus. Ct. Feb. 23, 2011) ("A claim for damages suffered by shareholders who . . . allege that they decided not to sell their shares because of an unduly rosy representation or a failure to disclose unfavorable material, after which there was a fall in the stock's value, is known as a 'holder claim.'"); Robert W. Taylor, Note, *Re-evaluating Holder Actions: Giving Defrauded Securities Holders a Fighting Chance*, 86 NOTRE DAME L. REV. 413, 415 (2011) (citing *Newby v. Enron Corp.* (*In re Enron Corp. Sec., Derivative & ERISA Litig.*), 490 F. Supp. 2d 784, 787 n.4 (S.D. Tex. 2007)).

26. 492 F. Supp. 714 (M.D.N.C. 1980).

27. See Plaintiff's Response to the Motion to Dismiss of Defendants G. Kennedy Thompson, Thomas J. Wurtz, Donald K. Truslow, Robert K. Steel, Wachovia Corporation, and Wells Fargo & Company (as Successor-In-Interest to Wachovia Corporation) and to the Motion to Dismiss of Defendant KPMG, LLP at 7, *Browne v. Thompson*, No. 09 CVS 8588, 2011 WL 1675000 (N.C. Bus. Ct. Feb. 23, 2011) (citing *Gilbert v. Bagley*, 492 F. Supp. 714, 734 (M.D.N.C. 1980)). In addition to *Gilbert*, the plaintiffs relied on the California Supreme Court's decision in *Small* to argue in support of recognition of holder claims in this particular case. See *id.* at 11–12. For a discussion of the holding and rationale in *Small*, see *infra* Part III.B.

28. N.C. GEN. STAT. § 55-35 (Supp. 1979), superseded by Act of June 8, 1989, ch. 265, § 1, 1989 N.C. Sess. Laws 516, 615–16 (codified at N.C. GEN. STAT. § 55-8-30 (2013)).

29. 270 N.C. 700, 155 S.E.2d 211 (1967).

30. See *Gilbert*, 492 F. Supp. at 733–35 ("There are . . . allegations that the Company's officers and directors caused or permitted certain false or misleading financial reports to be published. This, too, presents an individual claim.").

31. See *id.* at 734 (emphasis added).

*Gilbert* court had since been superseded.<sup>32</sup> In superseding the statute, the North Carolina General Assembly removed the duty that runs from the board of directors to the shareholders.<sup>33</sup> Thus, the court of appeals rejected the *Estate of Browne* plaintiffs' arguments and concluded that North Carolina law does not recognize holder claims.<sup>34</sup>

## II. LIMITATIONS ON HOLDER CLAIMS UNDER FEDERAL AND NORTH CAROLINA LAW

There are numerous laws relevant to regulating securities and defining appropriate causes of action for injured shareholders.<sup>35</sup> This Part demonstrates how securities regulations and the federal and state courts' narrow interpretations of such regulations have limited the availability of holder claims for injured shareholders in North Carolina.

### A. *Narrow Interpretations of Federal Securities Regulations*

Among federal regulations, SEC Rule 10b-5 is the most pertinent to *Estate of Browne* and similar cases that involve fraud or misrepresentation concerning securities. The SEC promulgated Rule 10b-5 to allow an investor to sue another person for fraud, deceit, misrepresentation, or material omission "in connection with the purchase or sale of any security."<sup>36</sup>

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32. See *Estate of Browne v. Thompson*, \_\_ N.C. App. \_\_, \_\_, 727 S.E.2d 573, 576 (2012) ("Gilbert relies on the premises that officers and directors owe a fiduciary duty to shareholders and that such duty is directly actionable by individual shareholders. In 1989, the General Assembly amended the statutes governing corporations, eliminating the provision that the directors' duty runs to both the shareholders and the corporation. 'The drafters [of N.C. GEN. STAT. § 55-8-30] recognized that directors have a duty to act for the benefit of all the shareholders of the corporation, but they intended to avoid stating a duty owed directly by the directors to the shareholders that might be construed to give shareholders a direct right of action on claims that should be asserted derivatively.' " (quoting RUSSELL M. ROBINSON, II, ROBINSON ON NORTH CAROLINA CORPORATION LAW § 14.01[2] (7th ed. 2012))).

33. See *id.*

34. See *id.*

35. See COX & HAZEN, *supra* note 19, § 27.5, at 734 (discussing various statutes including the Securities Act of 1933 and the Securities Exchange Act of 1934); see also *infra* Part II.B (discussing PSLRA and SLUSA).

36. 17 C.F.R. § 240.10b-5 (2013). This rule provides that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

In *Blue Chip Stamps v. Manor Drug Stores*,<sup>37</sup> the United States Supreme Court clarified that SEC Rule 10b-5's requirement that the injury occur "in connection with the purchase or sale of any security" meant that only *actual* buyers or sellers of securities could bring suit under the rule.<sup>38</sup> Such an interpretation means that would-be sellers—individuals who retained securities which they would have sold but for the misrepresentation—and would-be buyers—individuals who would have purchased securities but for the misrepresentation—fall outside of the protections of SEC Rule 10b-5.<sup>39</sup> A would-be seller is termed a "holder," and his or her claim for damages suffered after retaining securities in reliance on an officer's or director's misrepresentation is known as a "holder claim" or "holder's action."<sup>40</sup>

For the *Blue Chip Stamps* Court, the key arguments against allowing would-be buyers or would-be sellers to bring suit under SEC Rule 10b-5 were the "danger of vexatious litigation" and "the potential for nuisance or 'strike' suits."<sup>41</sup> "Vexatious litigation" or "'strike' suits" could lead to a number of problems, including: (1) delays of regular business operations; (2) "possible abuse of the liberal discovery provisions of the Federal Rules of Civil Procedure"; and (3) pressure on corporations to settle frivolous, non-meritorious claims in an attempt to avoid the hassle and expense of litigation.<sup>42</sup> The *Blue Chip Stamps* Court was also concerned with the weak degree of proof that may be involved if would-be buyers or sellers were permitted to bring claims under SEC Rule 10b-5, noting that a "[p]laintiff's entire testimony could be dependent upon

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(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

*Id.*

37. 421 U.S. 723 (1975).

38. *See id.* at 730–31.

39. *See id.* at 730–31, 737–38.

40. *See Small v. Fritz Cos.*, 65 P.3d 1255, 1256–57 (Cal. 2003) (defining a "holder's action" as "a cause of action by persons wrongfully induced to *hold* stock instead of selling it."); *see also Harris v. Wachovia Corp.*, No. 09 CVS 25270, 2011 WL 1679625, at \*11 (N.C. Bus. Ct. Feb. 23, 2011) ("A claim for damages suffered by shareholders who . . . allege that they decided not to sell their shares because of an unduly rosy representation or a failure to disclose unfavorable material, after which there was a fall in the stock's value, is known as a 'holder claim.'"); Taylor, *supra* note 25, at 415 (defining holder claims as "actions where the shareholder-plaintiff alleges that the defendant's misrepresentation induced him to continue holding his stock when he would have otherwise purchased or sold and seeks to recover for the diminished value of the stock suffered as a result").

41. *Blue Chip Stamps*, 421 U.S. at 740.

42. *Id.* at 740–41.



uncorroborated oral evidence of many of the crucial elements of his claim, and still be sufficient to go to the jury.”<sup>43</sup>

In a case like *Estate of Browne*, where the plaintiffs were not actual sellers but instead would-be sellers, the requirements under SEC Rule 10b-5 and *Blue Chip Stamps* mean that there is no cause of action under federal law for a plaintiff bringing suit in his or her individual capacity. But SEC Rule 10b-5 is not necessarily the end of the road for a would-be seller. As discussed below, states also provide causes of action with regard to securities fraud,<sup>44</sup> and some states permit far broader relief than is available under Rule 10b-5, including causes of action for holder claims brought by would-be sellers.<sup>45</sup>

### *B. Recent Federal Statutory Limitations on State Holder Claims*

Federal statutes have also placed significant limitations on state law securities actions. In 1995, Congress passed the Private Securities Litigation Reform Act (“PSLRA”)<sup>46</sup> in order to “deter[] frivolous and burdensome securities litigation” by “enact[ing] a number of reforms, including heightened pleading requirements and mandatory stays of discovery” for securities claims brought in federal court.<sup>47</sup> Thus, plaintiffs began bringing claims in state court to avoid the restrictions and added pleading requirements of PSLRA.<sup>48</sup> In response, Congress passed the Securities Litigation Uniform Standards Act (“SLUSA”) in 1998.<sup>49</sup> SLUSA allows state class action suits that involve fifty or more plaintiffs and that are brought “in connection with the purchase or sale of a covered security” to be removed to federal court.<sup>50</sup> Because SLUSA does not allow federal courts to hear securities-related class action suits that are based in state or common law, all the

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43. *Id.* at 746.

44. *See infra* Parts II.C, III.

45. *See infra* Part III.

46. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C. (2012)).

47. Bruce A. Ericson & Robert B. Bader, *Using Dabit, the Supreme Court Plugs a Gap in Federal Securities Laws to Preempt “Holder” State Law Class Action Claims*, SEC. LITIG. REP., June 2006, at 9.

48. *See id.*

49. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C. (2012)); *see* Ericson & Bader, *supra* note 47, at 9 (identifying the reduction of shareholder class actions as one of Congress’s intentions in enacting SLUSA).

50. 15 U.S.C. § 77p(b) (2012).

cases that defendants remove to federal courts are ultimately dismissed.<sup>51</sup>

While the initial ambiguity over whether the “in connection with the purchase or sale of a covered security” language in SLUSA was intended to include holder claims sparked a circuit split,<sup>52</sup> the United States Supreme Court resolved the issue in 2006 with its decision in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*.<sup>53</sup> The plaintiff-respondent in *Dabit* argued that the “in connection with” language of SLUSA should be construed narrowly to refer only to the same types of claims that are allowed under SEC Rule 10b-5’s “in connection with the purchase or sale of any security” language<sup>54</sup> and thus not extend to holder claims.<sup>55</sup> Such an interpretation would have the effect of exempting state holder claim class action suits with over fifty plaintiffs from removal and subsequent dismissal.<sup>56</sup> But the *Dabit* Court disagreed, concluding that the language of SLUSA does indeed cover holder claims.<sup>57</sup>

In sum, there is no federally recognized holder claim since SEC Rule 10b-5 provides relief only for actual buyers or sellers of securities, not would-be sellers.<sup>58</sup> If state law does happen to permit holder claims, SLUSA allows for a defendant to remove a class action suit involving fifty or more plaintiffs to federal court, where—if the class action is premised on a holder claim—the case will be dismissed.<sup>59</sup>

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51. See, e.g., *Prager v. Knight/Trimark Grp., Inc.*, 124 F. Supp. 2d 229, 231–32, 235 (D.N.J. 2000) (finding that, because SLUSA applied to the plaintiff’s claim, the defendant’s removal of the claim to federal court was proper and that dismissal of such claim was also proper); *Lasley v. New England Variable Life Ins. Co.*, 126 F. Supp. 2d 1236, 1239 (N.D. Cal. 1999) (same); see also *Ericson & Bader*, *supra* note 47, at 9 (“Because SLUSA prohibits class actions based on state or common law, such actions, once removed to federal court, are subject to immediate dismissal.”).

52. See *Ericson & Bader*, *supra* note 47, at 9 (“SLUSA does not define the phrase ‘in connection with the purchase or sale of a covered security.’ . . . The Second, Eighth, and Eleventh Circuits each interpreted SLUSA to cover only sellers and purchasers of securities, and not holders. The Seventh Circuit, on the other hand, rejected attempts by plaintiffs to plead around the ‘in connection with’ language by limiting their classes to holders of securities.”).

53. 547 U.S. 71 (2006).

54. See *supra* notes 36–38 and accompanying text.

55. See *Dabit*, 547 U.S. at 84.

56. See Matthew D. Haydo, Recent Decision, *A Class Action Securities Fraud Claim Brought Under State Law by Holders of Securities Is Preempted by a Federal Act Purporting to Encompass Claims Brought by Purchasers and Sellers: Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 45 DUQ. L. REV. 325, 326–27 (2007).

57. See *Dabit*, 547 U.S. at 82–88.

58. See *supra* notes 36–38 and accompanying text.

59. See *supra* notes 50–57 and accompanying text.

### C. North Carolina State Law Limitations

While SLUSA limits a party's ability to bring a securities claim in state court by authorizing removal in many circumstances, individuals and classes of forty-nine or fewer plaintiffs can still bring securities actions under state law since SLUSA applies only to classes of fifty or more plaintiffs.<sup>60</sup> Despite the federal restrictions, this means it is still possible to bring a holder claim if the laws of a given state recognize such a cause of action. Although SLUSA is quite limiting, it does not totally preclude holder claims under state law. The facts underlying *Estate of Browne* offer a prime example of a holder claim proceeding in state court without SLUSA removing the case to federal court, given that the suit was brought by only seven shareholders.<sup>61</sup> Therefore, it is still essential to consider what causes of action or limitations exist under the laws of a given state.

In North Carolina, the remedies available to individual shareholders who suffer financial losses are fairly limited.<sup>62</sup> Instead of allowing a direct suit brought by a shareholder in his or her individual capacity, North Carolina courts generally allow shareholders only to bring derivative actions against directors or officers who are engaging in fraud, misrepresentation, or otherwise harming the corporation.<sup>63</sup> A derivative action is a claim brought in the name of a corporation that is intended to benefit the corporation rather than the individual shareholder who brings the suit.<sup>64</sup> Presumably, a (rational) shareholder would bring suit directly as opposed to derivatively, since "recoveries in derivative actions generally accrue to the corporation," which only indirectly benefits the harmed shareholders.<sup>65</sup> North Carolina courts have justified this preference for derivative rather than direct suits on multiple grounds. First, creditors' superior rights to the corporation's funds could be adversely impacted by direct suits.<sup>66</sup> Second, directors do not owe a *direct* duty to each individual

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60. See *supra* notes 50–51 and accompanying text.

61. See *Estate of Browne v. Thompson*, \_\_ N.C. App. \_\_, \_\_, 727 S.E.2d 573, 574 (2012).

62. See *id.* at \_\_, 727 S.E.2d at 575 ("The well-established general rule is that shareholders cannot pursue individual causes of action against third parties for wrongs or injuries to the corporation that result in the diminution or destruction of the value of their stock." (quoting *Barger v. McCoy Hillard & Parks*, 345 N.C. 650, 658, 488 S.E.2d 215, 219 (1997)) (internal quotation marks omitted)).

63. See *id.* For a discussion of the *Barger* exceptions, see *infra* notes 69–73 and accompanying text.

64. See COX & HAZEN, *supra* note 19, § 15.2, at 443.

65. See *id.* at 444.

66. See *Harris v. Wachovia Corp.*, No. 09 CVS 25270, 2011 WL 1679625, at \*6 (N.C. Bus. Ct. Feb. 23, 2011).

shareholder, but rather, they owe this duty to the corporation.<sup>67</sup> Third, allowing individual claims could result in a flood of litigation.<sup>68</sup>

As noted previously, North Carolina has two exceptions, known as *Barger* exceptions, to its mandate requiring shareholders to sue derivatively.<sup>69</sup> The first of these exceptions—the “special duty” exception—applies “when the [defendant] performed individualized services directly for the shareholder” or “undertook to advise shareholders independently of the corporation,” among other instances.<sup>70</sup> The second exception—the “separate and distinct injury” exception—is more rare, and examples of events that may satisfy the second *Barger* exception are sparse.<sup>71</sup> However, the North Carolina Court of Appeals determined that the exception applied in *Norman v. Nash Johnson & Sons’ Farms, Inc.*,<sup>72</sup> a case where the minority shareholders of a closely held corporation suffered a separate injury from the majority shareholders of the corporation after the majority shareholders took business opportunities for themselves at the expense of the corporation.<sup>73</sup>

Outside of the two *Barger* exceptions, North Carolina provides no avenue for direct, individual shareholder action in response to fraudulent actions by directors or officers. North Carolina does not permit holder claims, as other states do,<sup>74</sup> and North Carolina courts have expressed reservations about permitting holder claims. For example, echoing concerns similar to those expressed by the *Blue Chip Stamps* Court,<sup>75</sup> the North Carolina Business Court recently

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67. See *Estate of Browne*, \_\_ N.C. App at \_\_, 727 S.E.2d at 576 (citing RUSSELL M. ROBINSON, II, ROBINSON ON NORTH CAROLINA CORPORATION LAW § 14.01[2] (7th ed. 2012)). Though the directors do not owe a *direct* duty to each individual shareholder, they do “have a duty to act for the benefit of all shareholders of the corporation.” *Id.*

68. See *Harris*, 2011 WL 1679625, at \*6.

69. See *Barger v. McCoy Hillard & Parks*, 345 N.C. 650, 658, 488 S.E.2d 215, 219 (1997); *supra* text accompanying notes 21–22.

70. *Barger*, 345 N.C. at 659, 488 S.E.2d at 220.

71. The *Barger* opinion simply stated a qualifying injury would have to be “separate and distinct from any damage suffered by the corporation,” without elaborating. *Id.* (quoting *Howell v. Fisher*, 49 N.C. App. 488, 492, 272 S.E.2d 19, 23 (1980) (internal quotation marks omitted)). Other opinions considering the second *Barger* exception have concluded that the exception was not met, without providing any specific description of what might satisfy the exception. See, e.g., *Energy Investors Fund v. Metric Constructors, Inc.*, 351 N.C. 331, 335–36, 525 S.E.2d 441, 444 (2000); *Gaskin v. J.S. Proctor Co.*, 196 N.C. App. 447, 457–58, 675 S.E.2d 115, 121 (2009); *Aubin v. Susi*, 149 N.C. App. 320, 328, 506 S.E.2d 875, 881 (2002) (Greene, J., concurring).

72. 140 N.C. App. 390, 537 S.E.2d 248 (2000).

73. See *id.* at 408, 573 S.E.2d at 260–61.

74. See *infra* Part III (discussing states that permit holder claims).

75. See *supra* text accompanying notes 41–43.

stated that “holder claims present substantive difficulties with regard to the elements of causation and damages in that by definition they are of a speculative nature that relies upon subjective and self-interested testimony.”<sup>76</sup> Similarly, the North Carolina Business Court criticized holder claims by noting that a remedy for an individual plaintiff would come “at the expense of other shareholders similarly situated.”<sup>77</sup> The court recognized that a successful holder claim action would require the corporation to pay damages to the shareholder bringing the suit, reducing the benefit payable to other shareholders who also suffered from the misrepresentations.<sup>78</sup>

In sum, an individual wishing to pursue a holder claim action faces a number of limitations. First, no federal law authorizes an action for holder claims, since the primary legal remedy for individuals—SEC Rule 10b-5—does not extend to holders or “would-be sellers” of stock who suffer losses. Second, to the extent that controlling state law permits holder claims, SLUSA limits potential remedial avenues by mandating that class action suits with fifty or more plaintiffs be removed to federal court where they will subsequently be dismissed. Finally, for an individual shareholder in North Carolina, there is no legal remedy at the state level for typical holder claims. This is a severe limitation on potential holder claims, allowing only holders falling in one of the narrow *Barger* exceptions to pursue an individual legal remedy.

### III. HOLDER CLAIMS IN OTHER STATES

To be sure, North Carolina is not alone in rejecting holder claims.<sup>79</sup> Nonetheless, courts in other states have recognized holder claims,<sup>80</sup> and this Part focuses on case law from two states in

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76. *Harris v. Wachovia Corp.*, No. 09 CVS 25270, 2011 WL 1679625, at \*12 (N.C. Bus. Ct. Feb. 23, 2011).

77. *Id.* at \*11.

78. *Id.*

79. See, e.g., *Arnlund v. Deloitte & Touche LLP*, 199 F. Supp. 2d 461 (E.D. Va. 2002); *Manzo v. Rite Aid Corp.*, No. Civ.A. 18451-NC, 2002 WL 31926606 (Del. Ch. Sept. 6, 2002); see also *Harris*, 2011 WL 1679625, at \*11 (citing cases from other states in support of the contention that other jurisdictions do not allow for holder claims).

80. In addition to New York and California, which are discussed in detail in this Part, other states, including Georgia, Massachusetts, and New Jersey, have recognized holder claims. See, e.g., *Holmes v. Grubman*, 691 S.E.2d 196, 199 (Ga. 2010); *Reisman v. KPMG Peat Marwick LLP*, 787 N.E.2d 1060, 1068 (Mass. App. Ct. 2003); *Duffy v. Smith*, 32 A. 371, 372 (N.J. 1895); see also Samuel T. Brannan, *Arguments and Authorities Supporting the Viability of Holder Claims*, PIABA B.J., Summer 2006, at 49 (arguing that holder claims have long been recognized in the common law of some states and the rules of some industries).

particular—New York and California. New York case law illustrates that New York courts have long recognized holder claims as valid actions. In addition, California provides a useful demonstration of how courts have judicially refined holder claims over time to respond to critiques of holder claims originally leveled by the *Blue Chip Stamps* Court.<sup>81</sup>

#### A. *New York*

New York has recognized holder claims since the 1927 case of *Continental Insurance Co. v. Mercadante*.<sup>82</sup> In that case, the defendant made misrepresentations regarding the solvency of a company in which the plaintiffs had purchased bonds.<sup>83</sup> These misrepresentations encouraged the plaintiffs to retain the bonds, which ultimately became “substantially worthless.”<sup>84</sup> The plaintiffs claimed that, had they been aware of the actual financial condition of the company, they would have sold the bonds.<sup>85</sup> Though the *Mercadante* court did not use the term “holder claim,” the description of the facts of the case indicate that the underlying issue in *Mercadante* is the same as what would now be considered a “holder claim.”<sup>86</sup> The *Mercadante* court highlighted the impact of the misrepresentation on the harmed shareholders, specifically noting that “[s]o far as respects the owner of property, his change of conduct [because of the fraud or misrepresentation] between keeping the property on the one hand, and selling it, on the other, is equally great.”<sup>87</sup>

Similar to the plaintiffs in *Estate of Browne*, then, the plaintiff in *Mercadante* altered his originally intended course of action because of fraud or misrepresentation and suffered a loss. The following hypothetical illustrates the radically different treatment under North Carolina law. Recall that Browne and his six co-plaintiffs stated that they decided to continue to hold onto their Wachovia stock in reliance on SEC filings, press releases, and other statements of the corporation which contained fraudulent information.<sup>88</sup> Assuming that

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81. See *supra* text accompanying notes 41–43 (discussing the critiques made by the *Blue Chip Stamps* Court).

82. 225 N.Y.S. 488 (N.Y. App. Div. 1927).

83. See *id.* at 489–90.

84. *Id.* at 490.

85. See *id.*

86. See *id.* (“The gravamen of the action is for fraud in inducing, not the purchase of the bonds, but their retention after purchase.”).

87. *Id.* (internal quotation marks omitted).

88. See *Estate of Browne v. Thompson*, \_\_ N.C. App. \_\_, \_\_, 727 S.E.2d 573, 575 (2012).

the *Estate of Browne* plaintiffs' allegations were true, they made the decision to retain their shares of Wachovia stock because of the falsely positive reports publicized by Wachovia officers and directors.<sup>89</sup> Now imagine that the hypothetical Jane Greene and six of her friends are watching the news when the reporter relays the information contained in a Wachovia press release—the same press release as the one relied upon by Browne and his co-plaintiffs.<sup>90</sup> Though they had not been intending to buy any Wachovia stock, the press release makes Greene and her six friends optimistic that Wachovia is doing well financially, and as a result, they call their respective brokers and purchase shares of stock. In 2008, the reality of Wachovia's poor financial condition is made public, and consequently, the corporation's stock plummets to less than twenty percent of its original value for Browne, Greene, and all of their friends.<sup>91</sup>

In North Carolina, Greene and her friends would have individual causes of action against the corporation because they were "actual purchasers" of the stock under SEC Rule 10b-5.<sup>92</sup> Yet Browne and his co-plaintiffs are left with no individual remedy in North Carolina despite the fact that they—just like Greene and her friends—were induced to change their intended course of action by Wachovia's misrepresentation and suffered equal financial detriment as a result. The logic of the *Mercadante* case highlights how arbitrary it is for North Carolina and many other states to allow the hypothetical Greene plaintiffs to recover their losses but to prevent individuals like Browne and his co-plaintiffs from doing the same.

In the decades since *Mercadante* laid the foundation for holder claims and articulated the rationale behind such claims, the field of securities has gone through much change.<sup>93</sup> Still, New York courts

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89. *See id.*

90. For examples of the positive information coming from the Wachovia officers, see Ieva M. Augstums, *Wachovia Says Golden West Doing OK*, WASH. POST (Aug. 23, 2007, 10:23 PM), <http://www.washingtonpost.com/wp-dyn/content/article/2007/08/23/AR2007082302016.html> ("[CEO] Thompson told analysts last month that looking ahead one to two years, 'we're going to be very happy we did this deal.'"); *Wachovia Chief Defends Golden West Merger*, TRIANGLE BUS. J. (Apr. 12, 2007, 2:00 PM), <http://www.bizjournals.com/triangle/stories/2007/04/09/daily28.html> ("Wachovia Corp.'s chief executive officer, Ken Thompson, said he remains confident that the bank's \$25 billion purchase last year of Golden West Financial will turn out to be a good deal . . . and that eventually the bank will be rewarded.").

91. *See Estate of Browne*, \_\_ N.C. App. at \_\_, 727 S.E.2d at 575.

92. *See supra* Part II.A (discussing the scope of SEC Rule 10b-5).

93. *See supra* Part II.A–B (discussing broad, controlling federal laws and influential Supreme Court decisions such as *Blue Chips Stamps*).

express support for holder claims based on the *Mercadante* decision.<sup>94</sup> In addition to holder claims specifically, *Mercadante*—and its argument that misrepresentations that detrimentally influence a plaintiff not to act are equally damaging under the law when compared with misrepresentations that induce affirmative action—have been positively cited by New York courts in other contexts.<sup>95</sup>

In sum, New York case law demonstrates that holder claims are not a new phenomenon. In pointing out the similarity of fraudulent inducement and harm to the plaintiff, *Mercadante* challenges the contentions that holder claims should not receive the same judicial treatment as cases involving the purchase or sale of securities.<sup>96</sup>

### B. California

More recently, California courts recognized holder claims but subjected such claims to particular pleading requirements in its 2003 decision in *Small v. Fritz Cos.*<sup>97</sup> In that case, the plaintiff alleged that the defendant corporation's directors substantially over-reported earnings in financial reports and that she made the decision to retain her stock because of the information contained in these reports.<sup>98</sup> Once the misrepresentations came to light, the value of the corporation's stock dropped dramatically, and the plaintiff brought

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94. See, e.g., *Babcock v. Citigroup, Inc.*, Index No. 602965/04, 2005 N.Y. Misc. LEXIS 8499, at \*7–8 (N.Y. Sup. Ct. Dec. 22, 2005). But see *Matana v. Merkin*, 13 Civ. 1534, 2013 U.S. Dist. LEXIS 107557, at \*35 (S.D.N.Y. July 30, 2013) (“[E]ven assuming that New York law would permit a satisfactorily pled holder claim along the lines of that in *Mercadante* [sic] to go forward . . .”).

95. See, e.g., *Hadden v. Consol. Edison Co. of N.Y.*, 382 N.E.2d 1136, 1137–39 (N.Y. 1978) (involving the issue of whether “plaintiff’s misrepresentation as exerted upon defendant employer was of such a character as to vitiate a waiver of the latter’s right to discharge plaintiff before he retired on a pension” and citing to *Mercadante* for the proposition that “[t]he inaction or refraining from action on the part of the employer . . . effected by such purposeful concealment of material facts was as culpable and actionable as where fraud induces positive action”); *Hiliel v. Motor Haulage Co.*, 140 N.Y.S.2d 51, 52, 54 (N.Y. Sup. Ct. 1955) (“This action is brought for damages resulting from an alleged fraud. It is claimed that by reason of a forgery committed by an employee of the defendant in erasing a notation of damage upon a warehouse receipt delivered by him to a customs broker acting on behalf of the plaintiffs, that the plaintiffs herein were lulled into a false sense of security as to the condition of the goods and therefore failed to enforce their rights . . . with the resultant lapse of the statute of limitations. . . . An active concealment has the same force and effect as a representation positive in form . . . and where it induces non-action where action would otherwise have been taken it is culpable as a fraud.”).

96. See *supra* text accompanying notes 41–43, 75–78 (presenting arguments against holder claims receiving the same judicial treatment).

97. 65 P.3d 1255 (Cal. 2003).

98. See *id.* at 1256–58.



suit.<sup>99</sup> Courts in other states, including North Carolina, have acknowledged and discussed the *Small* decision.<sup>100</sup>

Two key aspects of the *Small* decision are important to discuss here. First, the *Small* court found that the rationale undergirding *Blue Chip Stamps* did not apply to securities claims brought in state courts.<sup>101</sup> The California Supreme Court noted in *Small* that the *Blue Chip Stamps* Court did not intend for concerns of “vexatious” litigation or “strike” suits<sup>102</sup> to serve “as justification for a total denial of relief to defrauded holders; it only reasoned that the *federal* courts could deny a forum to wronged shareholders who are not sellers or buyers without unjust consequences because these stockholders retained a remedy in *state* courts.”<sup>103</sup> By limiting *Blue Chip Stamps* to federal courts, the *Small* court emphasized that the lack of federal remedy regarding holder claims is not fatal because would-be sellers can bring such actions in state court if a given state chooses to recognize holder claims.<sup>104</sup> It is worth noting that the California Supreme Court decided *Small*—with its focus on state courts as a

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99. *Id.*

100. See *Rogers v. Cisco Sys., Inc.*, 268 F. Supp. 2d 1305, 1314 (N.D. Fla. 2003) (“Assuming that Florida courts would recognize a cause of action in fraud or negligent misrepresentation for holding claims (and The Court believes they would), The Court also concludes that Florida courts would require the specificity in allegations of reliance recently recognized by the Supreme Court of California’s [*Small*] decision . . . .”); see also *Holmes v. Grubman*, 691 S.E.2d 196, 198–200 (Ga. 2010) (stating that “although we have determined that holder claims should be recognized under Georgia law, we further conclude that the limitations imposed in other jurisdictions are appropriate,” and citing *Small* among other cases in the relevant discussion); *Dloogatch v. Brincat*, 920 N.E.2d 1161, 1167–68 (Ill. App. 2009) (discussing the *Small* standard and concluding that the plaintiffs in the case did not meet the standard without definitively ruling on whether or not such standard should be adopted); *id.* at 1171–72 (Murphy, P.J., concurring in part and dissenting in part) (“I write separately because I would hold that a ‘holder’ cause of action exists in Illinois.”). In *Harris*, the court did not pass judgment on whether the *Small* approach was a sound decision, but instead it merely noted that “[t]he few courts [like the California Supreme Court in *Small*] that have recognized holder claims have imposed strict pleading requirements” and concluded that, even if North Carolina were to allow holder claims with pleading requirements similar to *Small*, the plaintiffs in the particular case would not have satisfied the requirements. See *Harris v. Wachovia Corp.*, No. 09 CVS 25270, 2011 WL 1679625, at \*12 (N.C. Bus. Ct. Feb. 23, 2011).

101. See *Small*, 65 P.3d at 1261.

102. See *supra* notes 41–43 and accompanying text.

103. *Small*, 65 P.3d at 1261.

104. See *id.* (“[T]he high court’s decision in *Blue Chip Stamps*, while recognizing policy considerations similar to those defendants advance here, did not view those considerations as justification for a total denial of relief to defrauded holders; it reasoned only that the federal courts could deny a forum to wronged stockholders who are not sellers or buyers without unjust consequences because these stockholders retained a remedy in state courts.”). Of course, these claims would be limited by removal of class action claims with fifty or more plaintiffs per SLUSA. See *supra* text accompanying notes 49–51, 57.

forum for securities litigation in certain circumstances—after Congress enacted PSLRA and SLUSA to limit such claims in federal court.<sup>105</sup> Thus, even though the *Small* decision construes the intention of the *Blue Chip Stamps* Court, it does so in light of the more recent changes in securities law that have made it more difficult to bring securities claims in federal court.

The second noteworthy aspect concerns policy. The *Small* court provided a compelling policy rationale for allowing holder claims in limited circumstances.<sup>106</sup> The defendants in *Small* advanced the oft-repeated argument that holder claims should not be allowed because permitting such claims would overwhelm courts and corporations with frivolous litigation.<sup>107</sup> In response, the court concluded that the risk of some individuals bringing meritless claims does not justify foreclosing legal remedies for all, given that some potential plaintiffs will have genuine claims.<sup>108</sup> Moreover, the *Small* court noted other indirect policy benefits that favor permitting holder claims, such as California's "interest in preserving a business climate free of fraud and deceptive practices,"<sup>109</sup> and the fact that permitting holder claims expands "substantially the number of persons who can enforce corporate honesty."<sup>110</sup>

Still, because of the risk of non-meritorious claims, the *Small* court held that a plaintiff bringing a holder claim must satisfy a heightened pleading requirement.<sup>111</sup> The court expanded on this idea by highlighting the type of information that must be included under this heightened pleading requirement:

In a holder's action a plaintiff must allege specific reliance on the defendants' representations: for example, that if the plaintiff had read a truthful account of the corporation's financial status the plaintiff would have sold the stock, how many shares the plaintiff would have sold, and when the sale would have taken place. The plaintiff must allege actions, as distinguished from unspoken and unrecorded thoughts and

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105. See *supra* Part II.B.

106. See *Small*, 65 P.3d at 1263–65.

107. See *id.* at 1263. The court noted that the "[d]efendants do not argue that a holder's suit for fraud is intrinsically unjust; instead, they claim that *some* of those suits will be nonmeritorious, or frivolous . . . ." *Id.*

108. See *id.*

109. *Id.* at 1264 (internal quotations omitted).

110. *Id.* at 1264–65.

111. See *id.* at 1265.

decisions, that would indicate that the plaintiff actually relied on the misrepresentations.<sup>112</sup>

Other courts have favorably cited this language from *Small* when discussing which pleadings might satisfy the heightened standard for holder claims.<sup>113</sup> In providing this caveat to its decision to permit holder claims, the California Supreme Court struck a balance between the interests of courts and corporations, who want to avoid frivolous litigation, and the interests of potential plaintiffs harmed by fraudulent or misleading statements of officers or directors.

#### IV. NORTH CAROLINA SHOULD ALLOW HOLDER CLAIMS

Presently in North Carolina, no direct recourse is available for individual shareholders in situations where they are misled into retaining their stock unless the shareholders fall into one of the *Barger* exceptions.<sup>114</sup> To provide equal footing for all shareholders who incur losses due to misrepresentations, North Carolina should adopt the *Small* court's approach to holder claims because the approach is logical and better accounts for competing interests.<sup>115</sup> Permitting holder claims while imposing heightened pleading requirements strikes an appropriate balance between protecting corporations and courts from a flood of litigation and advancing the interests of shareholders.<sup>116</sup> Thus, North Carolina should allow for shareholders to bring suits against a corporation whose stock they retained as a consequence of fraud or misrepresentation. However, such suits should be permitted only if, as in *Small*, the shareholder can adequately allege specific reliance on the misrepresentation.<sup>117</sup> This would be accomplished by pleading specific details, such as the number of shares the holder would have sold absent the misrepresentation, and by pointing to specific, external actions of the party making the misrepresentation to support his or her claim, among other details.<sup>118</sup>

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112. *Id.*

113. *See, e.g.,* *Rogers v. Cisco Sys., Inc.*, 268 F. Supp. 2d 1305, 1314 (M.D. Fla. 2003); *Holmes v. Grubman*, 691 S.E.2d 196, 198–200 (Ga. 2010); *Dloogatch v. Brincat*, 920 N.E.2d 1161, 1167–68 (Ill. App. 2009).

114. *See supra* Part II.C.

115. *See supra* text accompanying notes 106–12.

116. *See infra* Part IV.B–C.

117. *See Small*, 65 P.3d at 1266.

118. *See id.* at 1265 (noting that internal thoughts that are not expressed to others are insufficient to allege specific reliance). Because of the specificity required under *Small*, it seems likely that this would largely be a case-by-case analysis, and it is beyond the scope of this Recent Development to attempt to detail all possible circumstances that may satisfy

This Part begins by discussing the justifications for including holder claims among the pursuable causes of action in North Carolina securities law, highlighting why permitting holder claims would draw a less arbitrary line for legal remedies than the status quo. After discussing reasons supporting reform in North Carolina that would permit holder claims, this Part quells objections by explaining why inclusion of holder claims adequately balances the interests of corporations, courts, and shareholders.

*A. Justifications for Allowing Holder Claims in North Carolina*

Looking back to the reasoning of the *Mercadante* decision, an investor who changes his or her investment decisions based on fraud or misrepresentation suffers the same harm regardless of whether the fraud or misrepresentation induced the investor to buy stock that otherwise would not have been purchased or to hold onto stock that otherwise would have been sold.<sup>119</sup> Recall the example comparing Browne and his co-plaintiffs to the hypothetical Jane Greene and her friends.<sup>120</sup> Both Browne and Greene changed their investment behavior because of misrepresentations from the corporation, both were involved in a financial relationship with the corporation, and both suffered financial loss based on the misrepresentation. The only notable difference between Browne and Greene is the starting point—that is, where the parties were situated in relation to the corporation when they first heard the misrepresentations. However, this mere difference in starting point is quite an arbitrary divider for permitting relief for one group but not the other. From an overarching perspective, individuals like the hypothetical Jane Greene suffered harm that is equal to the harm suffered by Browne and his co-plaintiffs. Thus, there should be an equal opportunity for remedy.

Of course, extending this remedy exposes courts and corporations to a greater risk of frivolous litigation. However, this risk should not justify a blanket ban on all claims of holders.<sup>121</sup> As the

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this standard. However, the following example is one set of circumstances that may do so. It seems plausible that a document such as an email from a shareholder to his or her stockbroker stating that the stockbroker should not execute a previously requested sale of a specified number of shares in light of positive information the shareholder learned through the corporation's recent press release would satisfy the heightened pleading requirements.

119. See *supra* Part III.A.

120. See *supra* Part III.A.

121. Cf. Taylor, *supra* note 25, at 422–23 (“Congress and the courts have eliminated nearly *all* holder actions—rather than merely the frivolous ones. These actions prevent

*Small* court articulated, it is unfair for the courts to foreclose entirely a remedy to individuals who have also suffered financial losses from fraud merely because of the potential for frivolous litigation from some plaintiffs.<sup>122</sup> As discussed further in Part IV.B, depriving one party of a remedy merely because of a fear of non-meritorious claims of a third party is even less justifiable when considering the mechanisms—short of the blanket ban on all claims by holders currently in effect in North Carolina and many other states—that courts can utilize to reduce the risk of non-meritorious claims.

*B. Impact of the Proposed Solution on Corporations and Courts*

As the United States Supreme Court discussed in *Blue Chip Stamps*, the primary concerns with permitting securities-related suits by would-be purchasers or sellers center on the risk of “vexatious litigation” and “the potential for nuisance or ‘strike’ suits” that may interfere with business operations or result in “abuse of the liberal discovery provisions of the Federal Rules of Civil Procedure.”<sup>123</sup> Nonetheless, in light of the already existing federal limitations and the proposed heightened pleading requirements, these risks would ideally be mitigated for three reasons.

First, as discussed above, SLUSA and the *Dabit* decision provide protections for corporations and courts.<sup>124</sup> Even if North Carolina permitted holder claims, federal statutes and case law would continue to limit the power of holder claims in terms of the number, scope, and impact of such claims. If fifty or more plaintiffs were involved in a class action holder claim suit, then the suit would be removed to federal court under SLUSA, where it would then be dismissed because of the lack of recognition of holder claims under federal law.<sup>125</sup> The SLUSA and *Dabit* limitations curb the potential for overly powerful holder claims and help to alleviate the concerns of “vexatious litigation” expressed in *Blue Chip Stamps*.<sup>126</sup>

Second, the proposed heightened pleading requirements from *Small* would limit the number of claims that could be brought.

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even the most meritorious claims from being litigated.”) (citing Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711 (1996)).

122. See *supra* text accompanying notes 108–10.

123. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740–41 (1975).

124. See *supra* Part II.B.

125. See *supra* Part II.B.

126. *Blue Chip Stamps*, 421 U.S. at 740. This case was decided in 1975, more than twenty years before SLUSA or *Dabit* existed. See *supra* Part II.A.

Because of the high bar set by the *Small* pleading requirements,<sup>127</sup> it seems unlikely that courts would be inundated with frivolous litigation. This is particularly relevant in response to fears of potential abuse of the discovery process,<sup>128</sup> since only plaintiffs who overcome the high pleading bar would be able to engage in discovery. Relatedly, the proposed heightened pleading requirements respond to the *Blue Chip Stamps* Court's concerns regarding the dependence on "uncorroborated oral testimony"<sup>129</sup> and the North Carolina Business Court's criticism that holder claims are "of a speculative nature."<sup>130</sup> Under the *Small* approach, speculative allegations are not enough to satisfy the pleading standard; plaintiffs must prove their intent to sell through previously expressed statements and observable actions.<sup>131</sup> It may seem unlikely at present that an individual North Carolina shareholder would keep detailed records regarding motivations for decisions to retain shares. But if this standard were adopted, it seems plausible that some savvy shareholders may begin keeping records of such decisions if they find it necessary later to pursue a holder claim.<sup>132</sup>

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127. See *supra* text accompanying note 112.

128. See *Blue Chip Stamps*, 421 U.S. at 741 (discussing plaintiffs' ability to file meritless claims in order to engage in "extensive deposition of the defendant's officers and associates" as well as "extensive discovery of business documents").

129. See *id.* at 746.

130. *Harris v. Wachovia Corp.*, No. 09 CVS 25270, 2011 WL 1679625, at \*12 (N.C. Bus. Ct. Feb. 23, 2011).

131. See *supra* text accompanying note 112; see also Doug Winnard, Comment, *Know When to Hold 'Em, Know When to Fold 'Em: The Collapse of the Auction Rate Securities Market and the Problem of Standing for Securities Holders Under Rule 10b-5*, 104 NW. U. L. REV. 671, 701 (2010) ("[The *Small*] pleading requirements would effectively create a distinction between 'active holders' and 'passive holders.' Active holders are investors who can provide both objective evidence of actual reliance on the fraudulent misstatement and reliable details about the aborted sale. Passive holders, by contrast, are those investors who cannot produce any objective evidence of their aborted sale.").

132. See Winnard, *supra* note 131, at 701 (noting that only holders who are "active[ly]" involved in reviewing the statements of the corporation would be the sort of shareholders that would benefit from holder claims). For an example of what an investor could do to show that he or she is a would-be seller, see *In re Wash. Mut., Inc. Sec. Litig.*, No. 08-md-1919 MJP, 2010 U.S. Dist. LEXIS 113088, at \*17-19 (W.D. Wash. Oct. 25, 2010). The court denied the defendant's motion to dismiss the holder claims of one plaintiff, Monterey County Investment Pool, noting that it met the *Small* pleading standard by stating that

it received and reviewed the 2007 Form 10-K, both directly through its Bloomberg system and through its advisor, and relied upon such misrepresentations and concealments in deciding to hold on to its note. . . . [T]he Court finds that the date of reading is the same day WaMu made the SEC filing because the County alleges it would have sold its WaMu note the day the 2007 Form 10-K was filed. It cannot allege that it would have sold the note prior to having actually read the Form 10-K.

Finally, permitting holder claims would not result in a broadly expanded pool of potential plaintiffs. Anyone, even those individuals with no previous financial relationship with the corporation, can claim that they are “would-be purchasers.”<sup>133</sup> As a result, permitting “would-be purchasers” to bring claims would lead to a vast increase in potential plaintiffs. By contrast, holder claims are relevant only for current shareholders—those individuals who already hold stock in the corporation and can prove they are would-be sellers.<sup>134</sup> This requirement of a relationship limits the pool of potential plaintiffs to parties who have a pre-existing connection to the corporation and can point to specific instances where fraud or misrepresentation influenced their decision not to sell their shares of that corporation.

### *C. Impact of the Proposed Solution on Shareholders*

While the protections discussed above would ensure that corporations and courts do not face a flood of litigation, permitting holder claims would provide two key benefits for shareholders. First, permitting holder claims provides a previously non-existent remedy for some defrauded shareholders. Admittedly, as discussed in the preceding section, the number of shareholders impacted may be fairly low.<sup>135</sup> However, the goal of permitting holder claims is not to allow a new cause of action for every single shareholder but instead to expand slightly the possible causes of action available to certain defrauded shareholders who currently have no judicial recourse.

Second, aside from the direct benefit of providing an additional legal remedy for certain shareholders, permitting holder claims may have the indirect benefit of encouraging officers and directors to carry

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The County provides a detailed statement that had it read an accurate disclosure from WaMu in the 2007 Form 10-K it would have sold all of its interest in the WaMu on the date the filing was made. The County makes the same allegations as to the 2007 Form 10-K/A. These allegations are adequate under *Small*.

*Id.* (citations omitted) (internal quotation marks omitted).

133. See *Blue Chip Stamps*, 421 U.S. at 747 (“[B]ystanders to the securities marketing process could await developments on the sidelines without risk.”).

134. See *Small v. Fritz Cos.*, 65 P.3d 1255, 1266 (Cal. 2003).

135. To clarify the limited impact that the addition of a holder claim remedy may have, it is worth noting that the North Carolina Business Court in *Browne* discussed the *Small* approach and stated that “even if North Carolina were to recognize [holder] claims in limited discrete and narrow fact situations that are specifically and factually pled” like the approach from *Small*, “the allegations in the Complaint in this civil action as a matter of law are insufficient to meet such a standard.” *Browne v. Thompson*, No. 09 CVS 8588, 2011 WL 1675000, at \*5 (N.C. Bus. Ct. Feb. 23, 2011). Of course, this is not to say that the relevant factual circumstances necessarily existed in *Browne*, just that the plaintiffs did not plead them sufficiently if such circumstances did exist.

out their duties in good faith. As the *Small* court noted, “[d]enying a cause of action to persons who hold stock in reliance upon corporate misrepresentations reduces substantially the number of persons who can enforce corporate honesty.”<sup>136</sup> The addition of holder claims would increase the number of individuals who could hold corporate actors accountable and, by extension, perhaps dissuade corporations from fraud along the lines that Wachovia’s officers and directors committed in *Estate of Browne*.<sup>137</sup> Shareholders who are able to bring suits individually—and thus reap financial benefit directly rather than only in a derivative capacity—would have a greater motivation to bring suits and thus a greater motivation to personally monitor the actions of the officers and directors to ensure that they are not acting fraudulently.<sup>138</sup>

Securities litigation brought by private parties “is important not only as an ex post remedy for compensating shareholders and enforcing securities laws, but also as a means of deterring companies from engaging in fraudulent and illegal behavior.”<sup>139</sup> This argument is based on the idea that “those who commit white-collar crimes, such as securities fraud, act as rational, cost-benefit calculators.”<sup>140</sup> Under this logic, if holder claims are permitted, the additional risk of suit would factor into a director’s or officer’s decision regarding whether it was financially sensible to continue with the securities fraud.

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136. *Small*, 65 P.3d at 1264–65.

137. See *Estate of Browne v. Thompson*, \_\_ N.C. App \_\_, \_\_, 727 S.E.2d 573, 574–75 (2012) (“Plaintiffs contend that the individual defendants concealed information regarding underwriting standards, collateral quality, and necessary reserves for loans. Plaintiffs further contend that defendants issued false public SEC filings, press releases, and earnings calls regarding Wachovia’s financial strength and stability . . .”).

138. See ANTHONY OGUS, COSTS AND CAUTIONARY TALES: ECONOMIC INSIGHTS FOR THE LAW 108–09 (2006). Ogus notes that “civil law claimants typically gain personally from the remedy, notably damages, which the law confers on them and the ‘carrot’ may render them more diligent enforcers. Of course, for such an incentive to be operative, the benefits, financial and non-financial must exceed the costs of making legal claims . . .” *Id.* In the context of securities litigation, if a shareholder is able to proceed only derivatively—and thus would likely receive less financial gain from a successful suit when compared with someone who proceeds directly given that any damages award would first go back to the corporation before potentially being passed along to the shareholders (in much smaller quantities)—the potential financial benefits of bringing suit might not sufficiently off-set the expense of bringing suit, which, under Ogus’s view, seems to negate the incentive for “diligent enforce[ment].” *Id.*; see also *supra* text accompanying notes 63–65 (discussing derivative actions).

139. Taylor, *supra* note 25, at 426; see also THOMAS J. MICELI, THE ECONOMIC APPROACH TO LAW 288–90 (2004) (discussing how incentives can be used to make the law more efficient).

140. Taylor, *supra* note 25, at 426



## CONCLUSION

*Estate of Browne v. Thompson* involved seven Wachovia shareholders who retained stock after relying on misrepresentations regarding the financial stability of a failing company—but who were not provided with the same legal remedy available as actual buyers or sellers who suffered similar harms from the same misrepresentations. This decision of the North Carolina Court of Appeals highlights the inadequate relief provided under North Carolina law—namely the lack of judicial avenues for investors who retained securities that they otherwise would have sold because of fraud or misrepresentation.

Though policy reasons exist for not wanting to open the courts to shareholders in such cases, California has adopted a model that balances such policy concerns with the concerns of the shareholders. Thus, the balance struck in California in *Small*—and its added benefits for shareholders with accompanying safeguards against unnecessary burdens on courts and corporations—seems fair and logical in this regard and therefore should be adopted in North Carolina. Specifically, permitting holder claims would allow holders or would-be sellers of stock—a class of individuals who currently have no individual remedy in North Carolina—to pursue an individual cause of action against directors or officers who make misrepresentations that the shareholders rely on in retaining their stock. If North Carolina were to apply the *Small* standard in permitting holder claims, the possibility of added burdens on courts and corporations in the form of frivolous, non-meritorious litigation would be minimized.

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